Economic Trends

May 2009 (Covering April 10, 2009, to May 4, 2009)

In This Issue:

FEDERAL RESERVE BANK
of CLEVELAND

March Price Statistics

04.23.09
by Brent Meyer

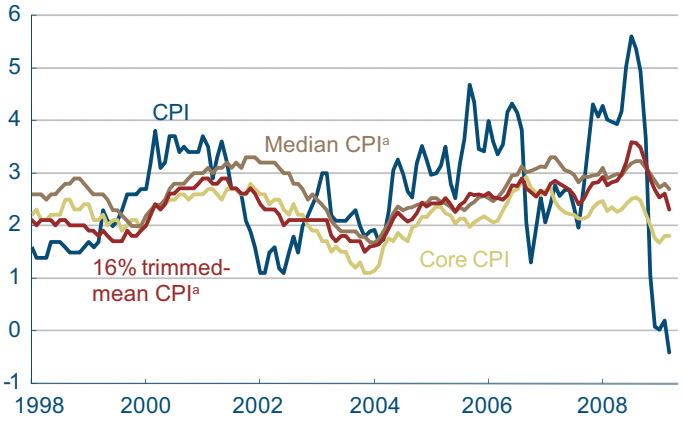
March Price Statistics

	Percent change, last					
	1mo.[a]	3mo.[a]	6mo.[a]	12mo.	5yr.[a]	2008 average
Consumer Price Index						
All items	−1.6	2.2	−5.4	−0.4	2.6	0.3
Less food and energy	2.1	2.2	1.2	1.8	2.2	1.8
Median[b]	2.0	2.3	2.0	2.7	2.8	2.9
16% trimmed mean[b]	0.4	1.7	1.0	2.3	2.6	2.7
Producer Price Index						
Finished goods	−13.1	−0.9	−13.8	−3.6	3.0	0.2
Less food and energy	0.0	2.6	2.6	3.8	2.5	4.3

a. Annualized.
b. Calculated by the Federal Reserve Bank of Cleveland.
Sources: U.S. Department of Labor, Bureau of Labor Statistics; and Federal Reserve Bank of Cleveland.

CPI, Core CPI, and Trimmed-Mean CPI Measures

12-month percent change



a. Calculated by the Federal Reserve Bank of Cleveland.
Sources: U.S. Department of Labor, Bureau of Labor Statistics, Federal Reserve Bank of Cleveland.

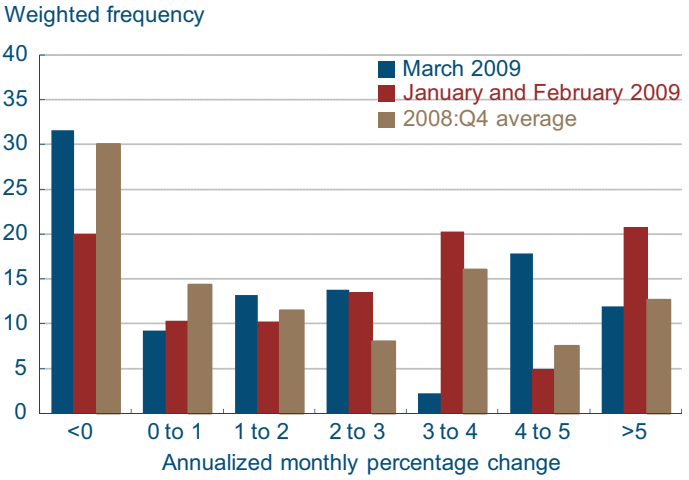
The CPI decreased at an annualized rate of 1.6 percent in March, pulling the 12-month growth rate down to –0.4 percent. Much of the decrease was due to reductions in energy prices, as fuel oil and other types of fuel prices fell 61.6 percent (annualized) and motor fuel prices decreased 42 percent during the month. Many food categories (dairy, meats, cereals, and fruits and vegetables) posted price declines as well.

Excluding food and energy (core CPI), the index rose 2.1 percent in March. The Bureau of Labor Statistics cautions that over 60 percent of the increase in the core CPI was due to a nonannualized 11.0 percent jump (251.4 percent at an annualized rate) in the prices of tobacco and smoking products. Excluding tobacco prices, the core CPI rose just 0.7 percent. The core CPI is up 2.2 percent over the past three months, compared to 1.8 percent over the past year. The measures of underlying inflation produced by the Federal Reserve Bank of Cleveland, the median CPI and the 16 percent trimmed-mean CPI, rose 2.0 percent and 0.4 percent, respectively.

Even though the 12-month growth rate in the overall CPI is negative, the core measures are currently trending between 1.8 percent and 2.7 percent. However, it is fairly evident that the inflationary environment has changed dramatically since last July, when the CPI was growing at 5.6 percent and the underlying inflation measures were trending up between 2.5 percent and 3.6 percent.

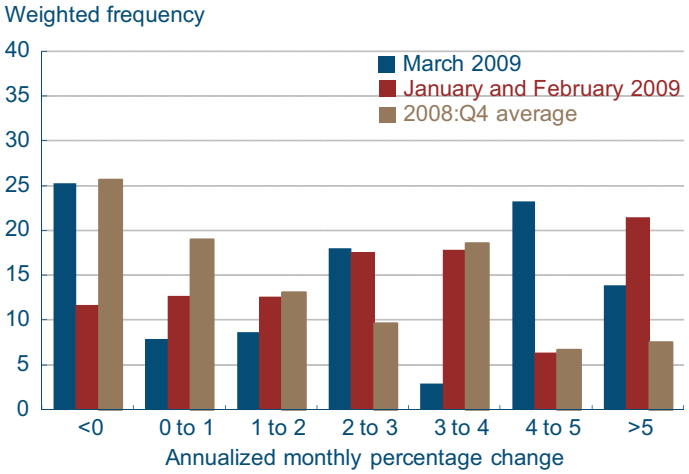
The underlying price-change distribution in March looks less like that of the last two months and more like that of the fourth quarter of 2008, when the median rose 1.8 percent and the 16 percent trimmed-mean rose just 0.3 percent on average. While some of the similarity is due to energy-price patterns (falling in the fourth quarter and March, rising in January and February), a quick glance at the core CPI price-change distribution (which

CPI Component Price Change Distribution



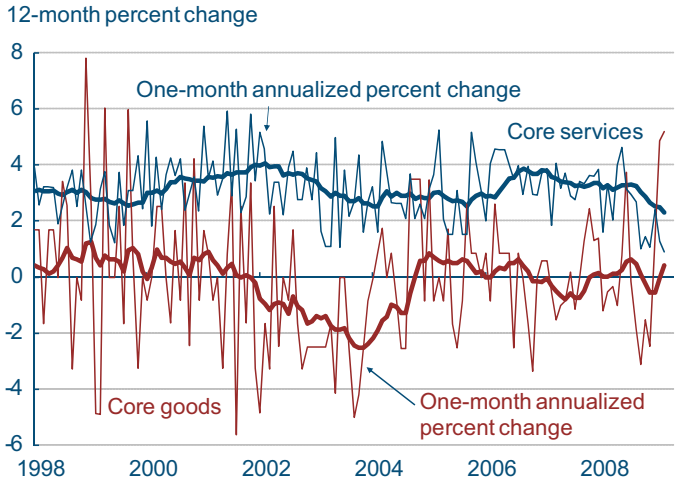
Source: Bureau of Labor Statistics.

Core CPI Component Price Change Distribution



Source: Bureau of Labor Statistics.

Core CPI Goods and Core CPI Services



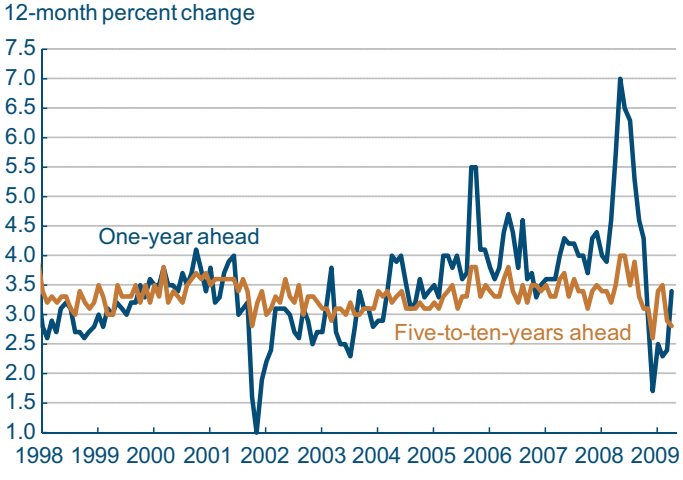
Sources: U.S. Department of Labor, Bureau of Labor Statistics.

removes food and energy prices) reveals that the pattern remains intact, even without these components.

In March, the 16 percent trimmed mean excluded most of the larger price increases, as only 12 percent of the consumer market basket rose at rates greater than 5.0 percent. The measure concurrently picked up on some of the downward price momentum, as roughly 32 percent of the index exhibited outright price decreases.

One-year-ahead average inflation expectations jumped up a full percentage point to 3.4 percent in April, perhaps suggesting a lessening in near-term deflation fears. However, April's jump was likely linked to recent increases in gas prices. In comparison, five-to-ten-year-ahead average inflation expectations ticked down to 2.8 percent from 2.9 percent, sliding further below the average over the past five years of 3.4 percent.

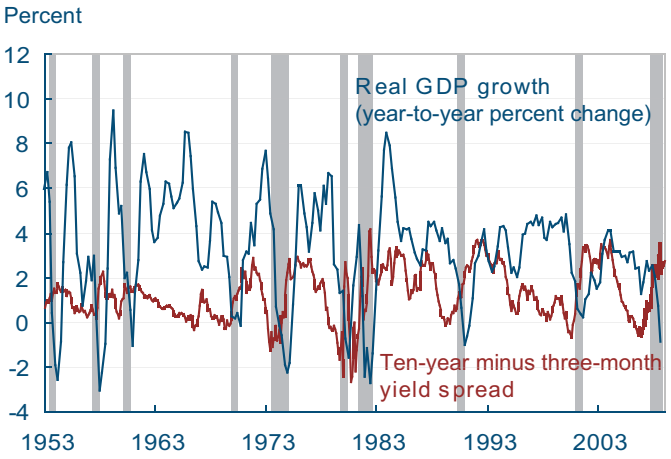
Household Inflation Expectations



Note: Mean expected change as measured by the University of Michigan's *Survey of Consumers*.
Source: University of Michigan.

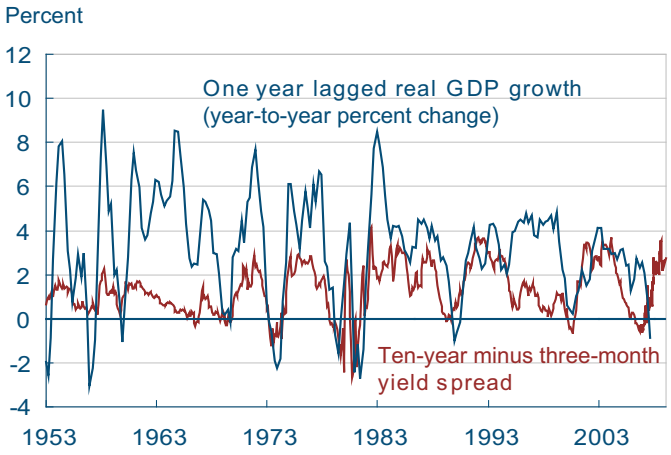
The Yield Curve, April 2009

Yield Spread and Real GDP Growth



Note: Shaded bars represent recessions
Sources: Bureau of Economic Analysis; Federal Reserve Board.

Yield Spread and Lagged Real GDP Growth



Sources: Bureau of Economic Analysis; Federal Reserve Board.

04.29.09
by Joseph G. Haubrich and Kent Cherny

Since last month, the yield curve has twisted steeper, with short rates dropping and long rates rising. The difference between short and long rates, the slope of the yield curve, has achieved some notoriety as a simple forecaster of economic growth. The rule of thumb is that an inverted yield curve (short rates above long rates) indicates a recession in about a year, and yield curve inversions have preceded each of the last seven recessions (as defined by the NBER). In particular, the yield curve inverted in August 2006, a bit more than a year before the current recession started in December, 2007. There have been two notable false positives: an inversion in late 1966 and a very flat curve in late 1998.

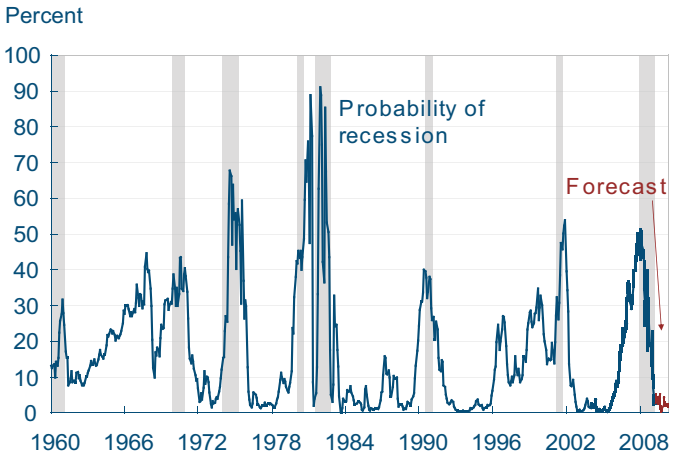
More generally, a flat curve indicates weak growth, and conversely, a steep curve indicates strong growth. One measure of slope, the spread between 10-year Treasury bonds and 3-month Treasury bills, bears out this relation, particularly when real GDP growth is lagged a year to line up growth with the spread that predicts it.

Since last month the 3-month rate edged downward from an already low 0.22 percent to an even lower 0.13 percent (for the week ending April 24). The 10-year rate increased from 2.75 percent to 2.96. This increased the slope to 283 basis points, a full 30 points higher than March's 253 basis points, and well above February's 258 basis points.

The flight to quality, the zero bound, and the turmoil in financial markets may impact the reliability of the yield curve as an indicator, but projecting forward using past values of the spread and GDP growth suggests that real GDP will grow at about a rate of 3.0 percent over the next year. This remains on the high side of other forecasts, many of which expect slower growth real GDP.

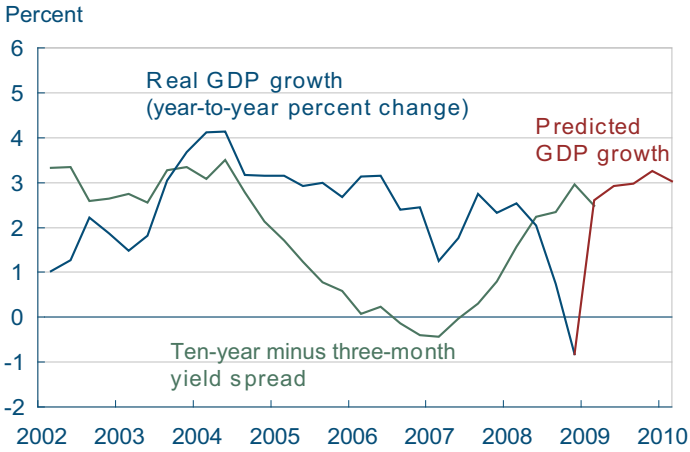
While such an approach predicts when growth is above or below average, it does not do so well in predicting the actual number, especially in the case of recessions. Thus, it is sometimes preferable to

Probability of Recession Based on the Yield Spread



Note: Estimated using probit model
Sources: Bureau of Economic Analysis, Federal Reserve Board, and authors' calculations

Predicted GDP Growth and Yield Spread



Sources: Bureau of Economic Analysis; Federal Reserve Board.

To read more on other forecasts:
http://www.econbrowser.com/archives/2008/11/gdp_mean_estima.html

For the *Wall Street Journal* survey:
http://online.wsj.com/article/SB123445757254678091.html

For Paul Krugman's column:
http://krugman.blogs.nytimes.com/2008/12/27/the-yield-curve-wonkish/

"Does the Yield Curve Yield Signal Recession?," by Joseph G. Haubrich. 2006. Federal Reserve Bank of Cleveland, *Economic Commentary* is available at:
http://www.clevelandfed.org/Research/Commentary/2006/0415.pdf

focus on using the yield curve to predict a discrete event: whether or not the economy is in recession. Looking at that relationship, the expected chance of the economy being in a recession next April stands at a very low 1.9 percent, up a bit from March's 1.1 percent and February's 0.98 percent.

The probability of recession coming out of the yield curve is very low and may seem strange in the midst of recent financial news. But one consequence of the financial environment has been a flight to quality, which lowers Treasury yields. Furthermore, both the federal funds target rate and the discount rate have remained low, which tends to result in a steep yield curve. Remember also that the forecast is for where the economy will be in a year, not where it is now. However, consider that in the spring of 2007, the yield curve was predicting a 40 percent chance of a recession in 2008, something that looked out of step with other forecasters at the time.

To compare the 1.9 percent probability of recession to what some other economists are predicting, head on over to the Wall Street Journal survey.

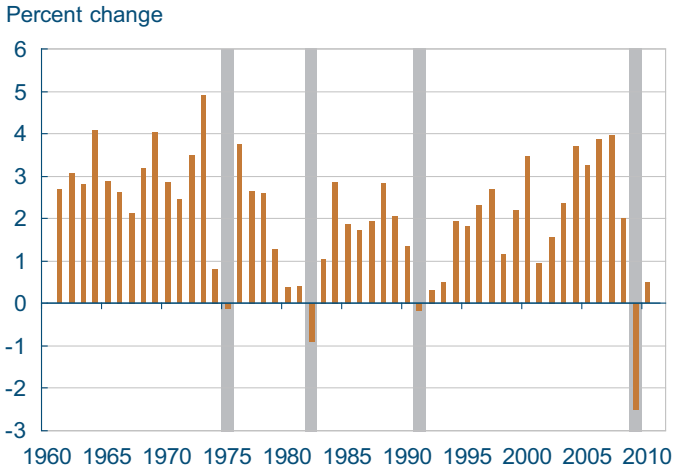
Of course, it might not be advisable to take this number quite so literally, for two reasons (not even counting Paul Krugman's concerns). First, this probability is itself subject to error, as is the case with all statistical estimates. Second, other researchers have postulated that the underlying determinants of the yield spread today are materially different from the determinants that generated yield spreads during prior decades. Differences could arise from changes in international capital flows and inflation expectations, for example. The bottom line is that yield curves contain important information for business cycle analysis, but, like other indicators, they should be interpreted with caution.

For more detail on these and other issues related to using the yield curve to predict recessions, see the Commentary "Does the Yield Curve Signal Recession?"

Mighty Bad Recessions

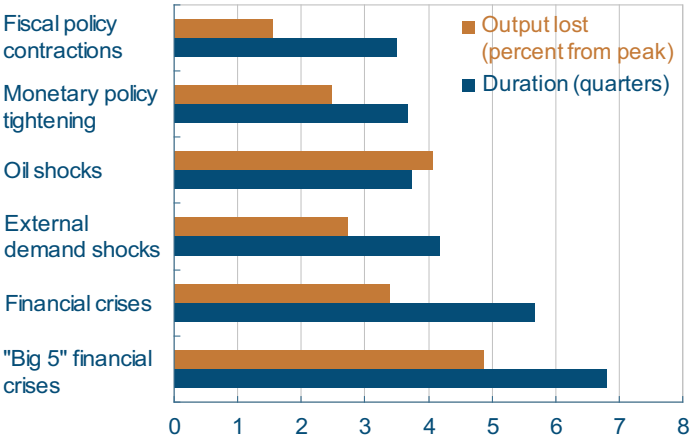
05.04.09
by Owen F. Humpage and Michael Shenk

Real Per Capita World GDP Growth



Source: International Monetary Fund, *World Economic Outlook*, April 2009.

Average Recession Statistics



Source: International Monetary Fund, *World Economic Outlook*, April 2009.

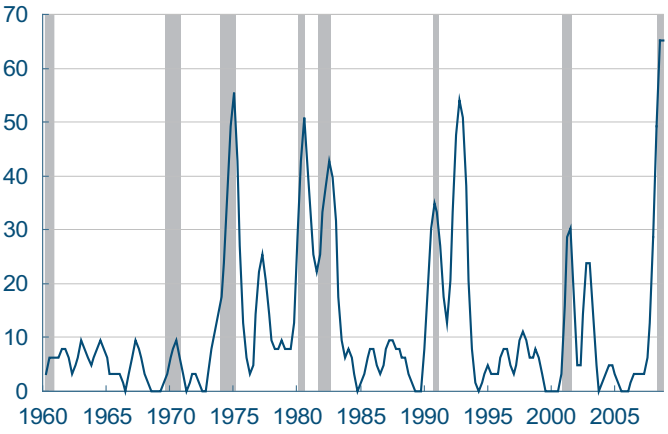
No two recessions are exactly alike. They differ in terms of their depth and duration, their diffusion across various industries, and the economic shocks that set them off. Nevertheless, recessions often share basic characteristics that determine their severity and the pace of subsequent recoveries. Recently, the International Monetary Fund (IMF) has been studying two of these—association with a financial crisis and global reach—to see how they affect a recession's contours. The implications for our current global economic malaise, which shares both of these characteristics, are sobering. They explain why the current global downturn is the worst since the Great Depression.

The IMF investigated business cycles which occurred between 1960 and 2007 in 21 advanced countries. Researchers wanted to know if recessions associated with financial shocks and recessions highly synchronized across countries were distinct in their depth and duration from recessions with different characteristics. The sample yielded 122 recessions, 15 of which were associated with financial crises, 37 of which were highly synchronized across the globe, and 6 of which got a double whammy.

Recessions associated with financial crises are deeper and longer lasting than recessions associated with other types of economic shocks. In addition, their recoveries are slow and prolonged. Such recessions tend to follow periods of rapid credit growth, involving overheated goods and labor markets, housing booms, and a loss of international competitiveness. Rapid credit growth often results in low household savings rates and a deterioration in household balance sheets. After the credit bubble bursts, a long period of retrenchment ensues. Demand remains weak, especially in areas of the economy dependent on credit, like residential and business investment.

Recessions that are highly synchronized across countries are likewise deeper and longer lasting

Highly Synchronized Recessions



Note: Shaded bars indicate U.S. recessions.
Source: International Monetary Fund, *World Economic Outlook*, April 2009.

than other recessions. When a good portion of the globe is in recession, exports cannot provide a way out, and hence recoveries are slow and protracted. The IMF found that highly synchronized global recessions typically followed or coincided with recessions in the United States. When the U.S. sneezes, the rest of the world catches cold.

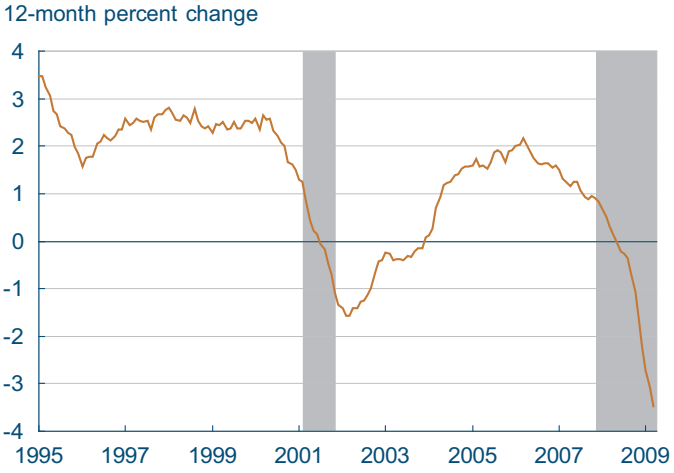
Combine a global recession with a financial crisis, as is currently the case, and you have the worst of all possible situations. The current global contraction is deep and the recovery will be drawn out.

The IMF also compared the effectiveness of monetary and fiscal policies in recessions associated with financial crises to economic contractions triggered by other events. In recessions not associated with financial crises, expansionary monetary policies shortened the duration of the downturn and promoted faster recoveries, but fiscal policies have no noticeable effect. During recessions associated with a financial crisis, however, monetary policy, which operates mainly through banks and interest rates, is ineffectual, while fiscal policy gains some bite. That said, the effectiveness of fiscal policies wane rapidly during the recovery phase in countries saddled with high levels of public debt.

For more information on the IMF's study on recessions:
http://www.imf.org/external/pubs/ft/weo/2009/01/pdf/c3.pdf

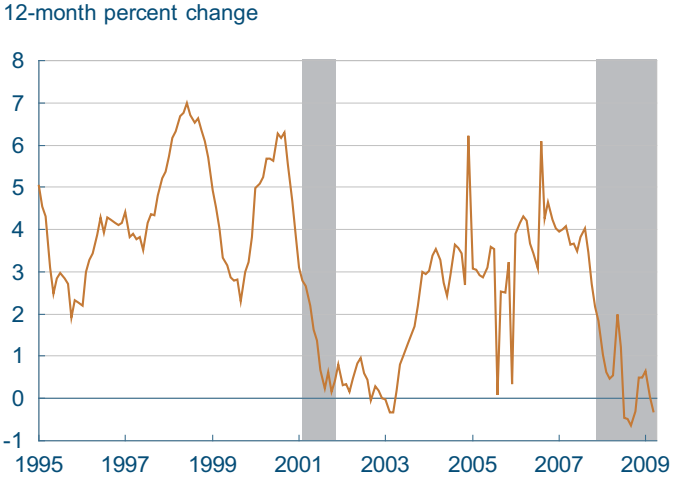
The Changing Composition of Consumption

Nonfarm Payroll Employment



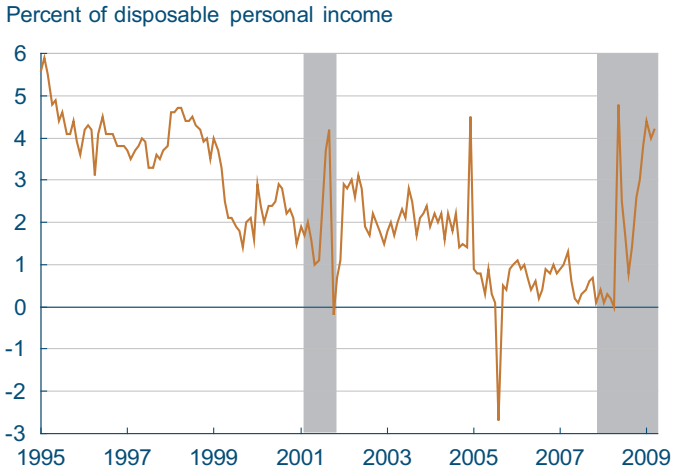
Source: Bureau of Labor Statistics.

Real Personal Income



Source: Bureau of Economic Analysis.

Personal Savings Rate



Source: Bureau of Economic Analysis.

05.04.09
by Paul Bauer and Michael Shenk

It is no secret that some households are being hit hard in the current recession. Nonfarm payroll employment is down about 3.5 percent over the last year. Real personal income is down 0.3 percent over the same time period. Both of these phenomena are fairly typical of a recession, but in this recession they are particularly severe. The ongoing job losses, lower housing wealth, and tight credit of this financial crisis have led to some abrupt shifts in household consumption behavior.

The most prominent shift is that the personal saving rate leaped to over 4 percent from nearly zero in this recession. It did so temporarily when the first stimulus checks hit households in May 2008, but jumped up again, apparently more lastingly, after last fall's financial fireworks. While for years financial advisors have urged Americans to raise their personal savings rate, such a quick shift has had jarring effects elsewhere in the economy.

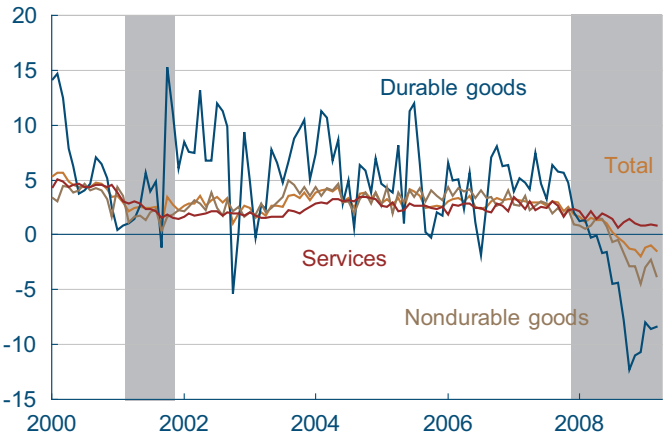
A related shift, driven by increased saving and the flat growth in real personal income, is a highly unusual drop in consumption. In the last recession, the growth in real personal consumption expenditures slowed but did not fall below zero. Real personal consumption expenditures (PCE) fell 3.8 percent and 4.3 percent in the last two quarters of 2008. It has since rebounded, expanding 2.2 percent in the first quarter of 2009.

Not only has consumption declined in this recession, but its composition has shifted as well. Looking at monthly data, the durable goods component (14 percent of PCE) has plummeted and is currently down over 8.4 percent from a year ago. Nondurable goods (about 28 percent of PCE) have slowed less, but they still declined an unusual 3.8 percent. Only services (58 percent of PCE) have managed to eke out a positive gain (0.9 percent).

The clear pattern is that consumers are saving by deferring consumption wherever they can, but this is easier to do with long-lived durable goods and

Real Personal Consumption Expenditures

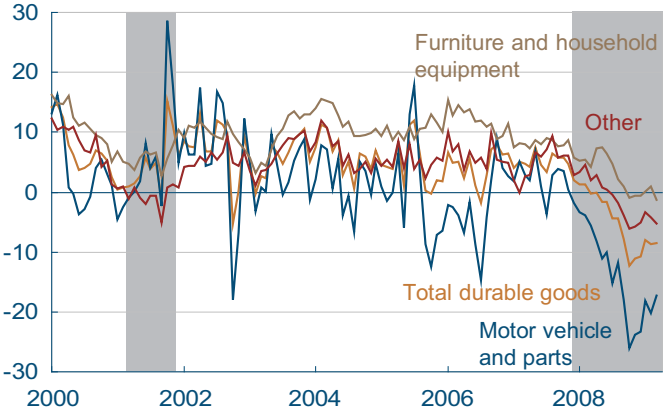
12-month percent change



Source: Bureau of Economic Analysis.

Real Personal Consumption Expenditures: Durable Goods

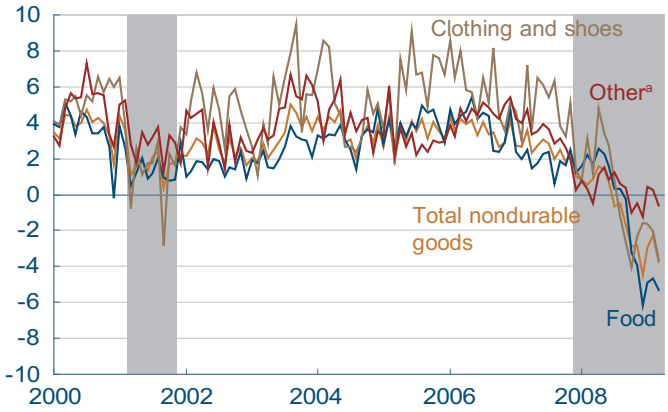
12-month percent change



Source: Bureau of Economic Analysis.

Real Personal Consumption Expenditures: Nondurable Goods

12-month percent change



a. Does not include gasoline, fuel oil or other energy goods.
Source: Bureau of Economic Analysis.

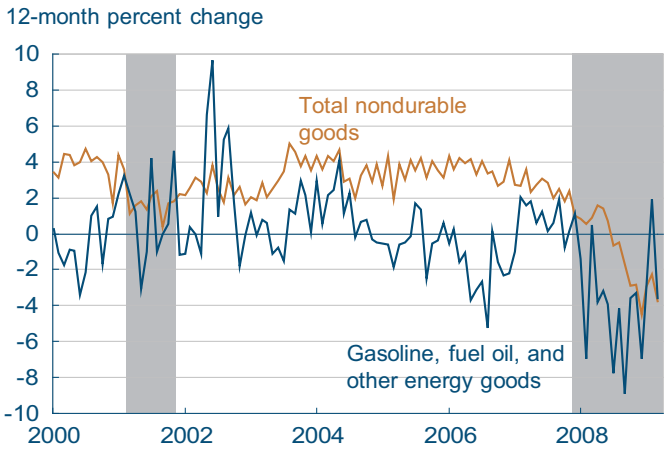
less so with services. For example, households can delay replacing their cars (a durable good) without too much difficulty, but deferring oil changes (a service) is not as wise. A consequence is that auto repair shops and other service providers that extend the life of goods are faring better than manufacturers of new goods.

Looking at the components of durable goods, it should surprise no one that motor vehicles and parts (31 percent of durable goods) have been particularly hard hit. They are currently down about 17.2 percent year-over-year. Furniture and household equipment (54 percent of durable goods) has born up better and is essentially flat year-over-year.

All the main categories of nondurable good—food, clothing and shoes, and gasoline, fuel oil, and other energy goods—are down in this recession. Note the nondurable category "food" (46 percent of nondurables) includes restaurant meals, so food's 5.3 percent year-over-year decline does not mean people are eating less, just that they are eating out less often and spending less when they do.

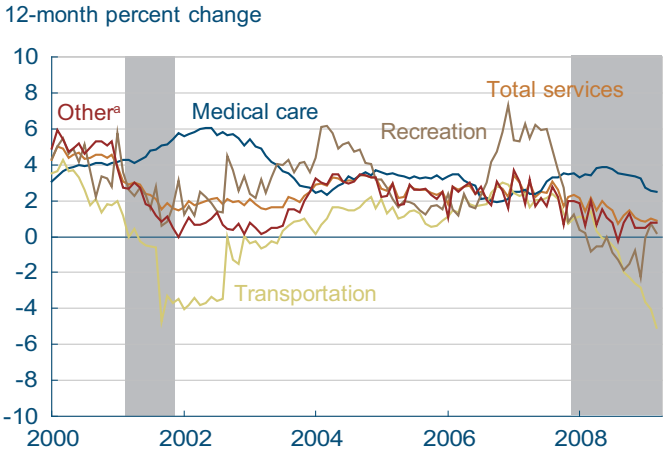
Although services have fared better, some have performed better than others. As typically happens in a recession, medical care (nearly 30 percent of services) has held up fairly well—it's currently up 2.5 percent year-over-year—but it is not performing as well as in previous recessions. With many households securing their health insurance through their employers, the heavy employment losses in this recession have had an adverse effect on coverage and ultimately care and treatment. Real expenditures on recreation (7 percent of services) dropped early in this recession but are currently up 0.2 percent year-over-year. Transportation services (6 percent of services) continue to take it on the chin, dropping over 5 percent over the last year.

Real Personal Consumption Expenditures: Nondurable Goods



Source: Bureau of Economic Analysis.

Real Personal Consumption Expenditures: Services



a. Includes housing, housing operation, and other.
Source: Bureau of Economic Analysis.

How permanent will the shifts toward saving and thus slower consumption be, particularly for durable goods? While the life of durable goods can be extended, albeit at the cost of higher maintenance, at some point they have to be replaced. A higher savings rate is likely to persist, but demand for durable goods is likely to rebound at least partially. Having been burned once, households may be reluctant to spend as much on housing and autos as in the past.

Real GDP: First-Quarter 2009 Advance Esitmate

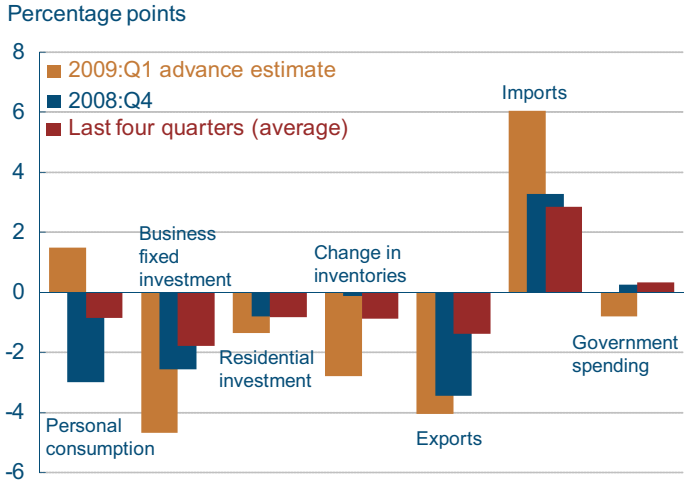
05.04.09
by Brent Meyer

Real GDP and Components, 2009:Q1 Advance Estimate

	Quarterly change (billions of 2000$)	Annualized percent change, last: Quarter	Four quarters
Real GDP	−181.2	−6.1	−2.6
Personal consumption	43.7	2.2	−1.2
Durables	25.3	9.4	−8.3
Nondurables	7.6	1.3	−3.0
Services	17.1	1.5	0.9
Business fixed investment	−150.5	−37.9	−16.36
Equipment	95.2	−33.8	−19.6
Structures	−46.0	−44.1	−10.0
Residential investment	−37.4	−38.0	−23.2
Government spending	−20.9	−3.9	1.7
National defense	−9.1	−6.4	5.2
Net exports	56.1	—	—
Exports	−123.9	−30.0	−11.3
Imports	−179.9	−34.1	−16.5
Private inventories	−103.7	—	—

Source: Bureau of Economic Analysis.

Contribution to Percent Change in Real GDP



Source: Bureau of Economic Analysis.

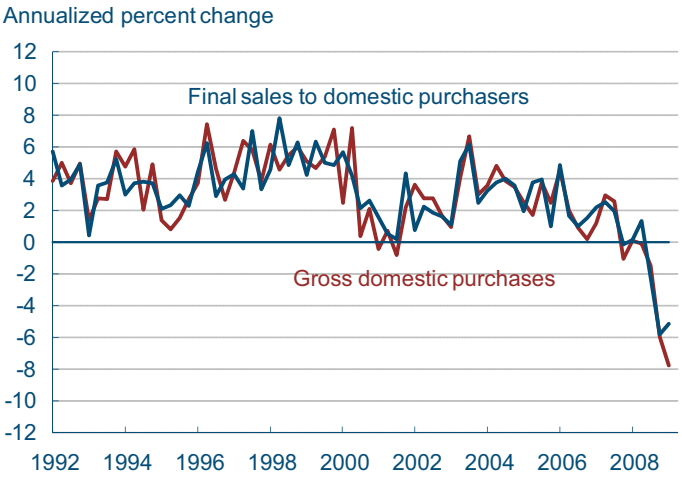
Real GDP decreased at an annualized rate of 6.1 percent in the first quarter of 2009, slightly less negative than the fourth quarter's −6.3 percent, but coming in worse than consensus expectations. The resulting four-quarter growth rate in real GDP fell to −2.6 percent, its lowest growth rate since the 1982 recession. The first-quarter decrease was driven by negative contributions from business fixed investment, exports, and private inventories, and it was partially offset by consumption gains and a decrease in imports (which adds to real GDP).

Nonresidential fixed investment posted its sharpest postwar decrease, plummeting 37.9 percent in the first quarter and taking 4.7 percentage points away from real GDP growth. Real exports decreased 30.0 percent in the first quarter, subtracting 4.1 percentage points from growth and pushing the year-over-year growth rate down to −11.3 percent. However, imports fell even further, declining 34.1 percent during the quarter, which led to net exports actually adding 2.0 percentage points to real GDP growth.

Real personal consumption expenditures increased 2.2 percent (more than was expected), following two consecutive quarterly decreases. Spending on consumer durables jumped up 9.5 percent during the quarter, after four consecutive quarterly decreases. Embedded in the upside surprise in the quarterly consumption data were upward revisions to the monthly series. In fact, January's estimate was revised up from an initial estimate of 4.6 percent to 10.8 percent. The sell-off in private inventories accelerated in the first quarter, subtracting 2.8 percentage points from growth, compared to a mere 0.1 percentage point in the fourth quarter.

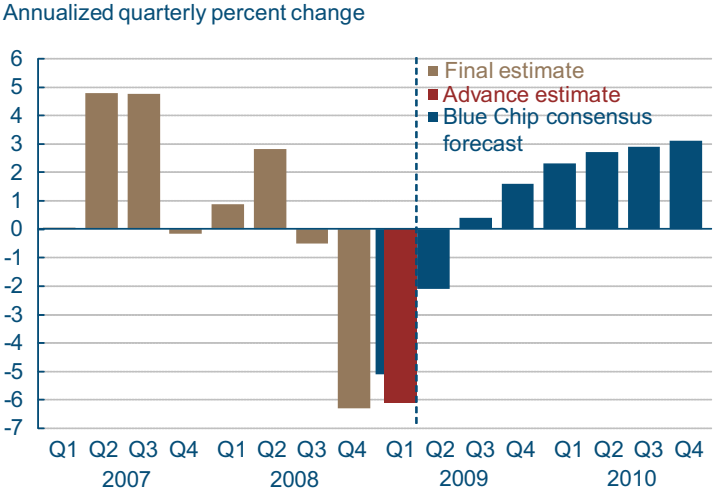
Given the wild swings in the international trade data and private inventories, it might be useful to examine output changes that exclude those series. Real gross domestic purchases—which ignore net exports—fell 7.8 percent in the first quarter, fol-

Gross Domestic Purchases and Final Sales



Source: Census Bureau.

Real GDP Growth



Sources: *Blue Chip Economic Indicators*, April 2009; Bureau of Economic Analysis.

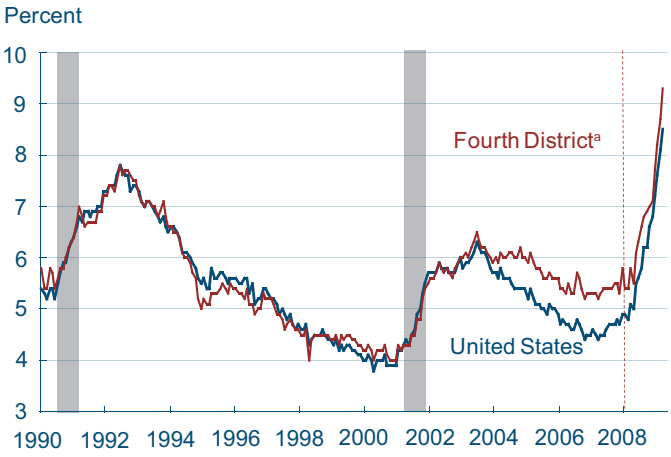
lowing a 5.9 percent decrease last quarter. However, this series still includes the change in private inventories, which decreased dramatically in the first quarter. Final sales to domestic purchasers, a measure of domestic demand, excludes inventory changes in addition to subtracting net exports. Final sales decreased 5.1 percent in the first quarter, improving over the 5.8 percent falloff in the fourth quarter, and may offer some hope that demand is starting to return.

Panelists on the Blue Chip survey actually revised up their first-quarter growth estimate in the April survey (which takes place during the first week of April)—from –5.3 percent to –5.1 percent. Unfortunately, real GDP came in below expectations. That said, the consensus viewpoint is for the recession to end by midyear and to rebound toward trend growth by the fourth quarter of 2010.

Fourth District Employment Conditions, March 2009

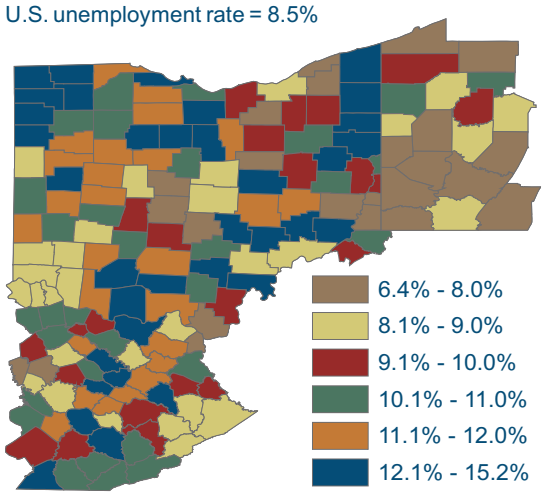
04.30.09
by Kyle Fee

Unemployment Rates



a. Seasonally adjusted using the Census Bureau's X-11 procedure.
Note: Shaded bars represent recessions. Some data reflect revised inputs, reestimation, and new statewide controls. For more information, see http://www.bls.gov/lau/launews1.htm.
Source: U.S. Department of Labor, Bureau of Labor Statistics.

County Unemployment Rates



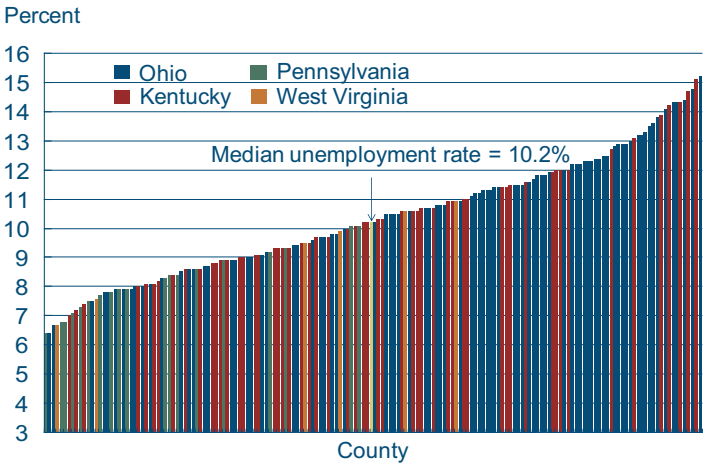
Note: Data are seasonally adjusted using the Census Bureau's X-11 procedure.
Source: U.S. Department of Labor, Bureau of Labor Statistics.

The District's unemployment rate increased 0.5 percentage point to 9.3 percent for the month of March. The increase in the unemployment rate is attributed to an increase of the number of people unemployed (5.4 percent) and a decrease in the number of people employed (–0.8 percent). The District's unemployment rate was again higher than the nation's (0.8 percentage point), as it has been consistently since early 2004. Since the recession began, the nation's monthly unemployment rate has averaged 0.6 percentage point lower than the Fourth District unemployment rate. Year over year, the Fourth District and the national unemployment rates have increased 3.5 percentage points and 3.4 percentage points, respectively.

There are significant differences in unemployment rates across counties in the Fourth District. Of the 169 counties that make up the District, 36 had an unemployment rate below the national rate in March, and 133 counties had a higher rate. There were 92 District counties reporting double-digit unemployment rates, 63 percent of which were in the state of Ohio. Rural counties continue to experience higher levels of unemployment, as do counties along the Ohio-Michigan border. More recently, counties on the Ohio side of the Ohio-Pennsylvania border have seen spikes in unemployment rates. Outside of Pennsylvania, lower levels of unemployment are limited to the interior of Ohio or the Cleveland-Columbus-Cincinnati corridor.

Unemployment rates across Fourth District counties range from 6.4 percent (Allegheny County, Pennsylvania) to 15.2 percent (Williams County, Ohio), with a median county unemployment rate of 10.2 percent. Counties in Fourth District Pennsylvania generally populate the lower half of the distribution of unemployment rates across counties, while the few Fourth District counties in West Virginia moved to the middle of the distribution in March. Fourth District Kentucky and Ohio counties continue to dominate the upper half of the

County Unemployment Rates



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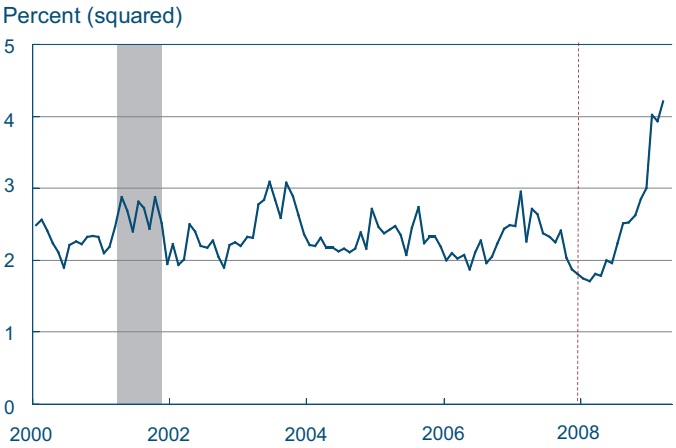
Source: U.S. Department of Labor, Bureau of Labor Statistics.

Variance of County Unemployment Rates



Source: U.S. Department of Labor, Bureau of Labor Statistics.
Note: Shaded bars represent recessions.

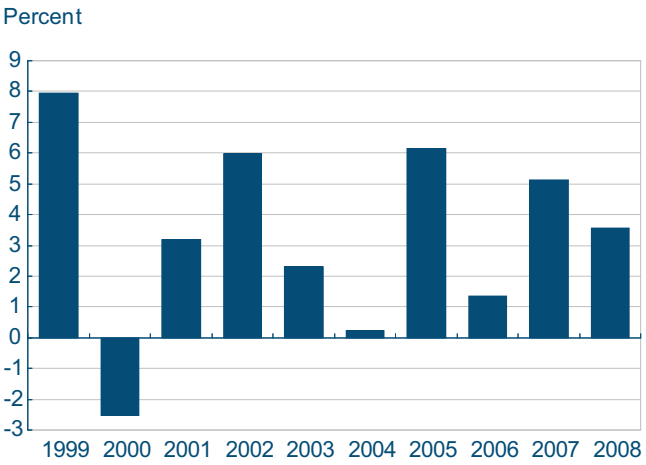
distribution. These county-level patterns are reflected in statewide unemployment rates, as Ohio and Kentucky have unemployment rates of 9.7 percent and 9.8 percent, respectively, compared to Pennsylvania's 7.8 percent and West Virginia's 6.9 percent.

Unemployment rates vary now more across Fourth District counties than they did earlier this decade. Increased dispersion of unemployment rates supports the notion that labor markets in some Fourth District areas are holding up relatively well, while other areas have experienced much higher levels of unemployment.

Fourth District Bank Holding Companies

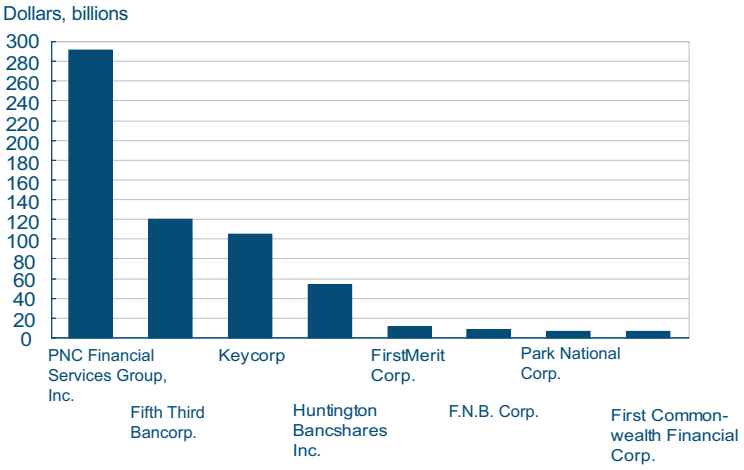
04.13.09
by Joseph Haubrich, Kent Cherny, and Saeed Zaman

Annual Asset Growth



Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Fourth Quarter 2008.

Largest Fourth District Bank Holding Companies by Asset Size



Note: Rank is as of fourth quarter 2008.
Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Fourth Quarter 2008.

A bank holding company (BHC) is a legal entity that owns a controlling interest in a commercial bank, often in addition to other financial and nonbank subsidiaries. BHCs range in size, but all are regulated by the Federal Reserve System (each BHC is supervised by the Federal Reserve Bank in the region where the BHC has its headquarters).

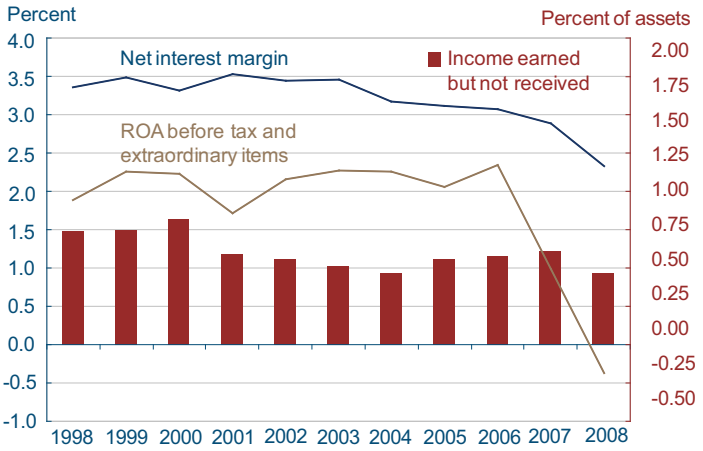
Of those BHCs with consolidated assets of more than $1 billion, 20 were headquartered in the Fourth District, including 4 of the top 50 BHCs in the United States, as of the fourth quarter of 2008.

Annual asset growth of Fourth District BHCs was 3.5 percent last year, down from 2007's 5.1 percent growth rate. With regard to national trends, the commercial banking sector saw a reduction in total assets during the fourth quarter of 2008, as the financial crisis prompted banks to deleverage or slow their rate of asset growth. Nevertheless, total assets nationally and in the Fourth District did grow over the course of 2008.

The landscape of Fourth District BHCs has changed slightly since our last update. In particular, the Pittsburgh-based bank PNC closed on its purchase of Cleveland-based National City during the fourth quarter of last year, becoming the eighth largest BHC in the country (with assets of $291 billion). Fifth Third, Key, Huntington Banks, and other large BHCs located in the District, are also among the top 50 U.S. BHCs. The assets of all Fourth District BHCs account for 4.6 percent of the nationwide total.

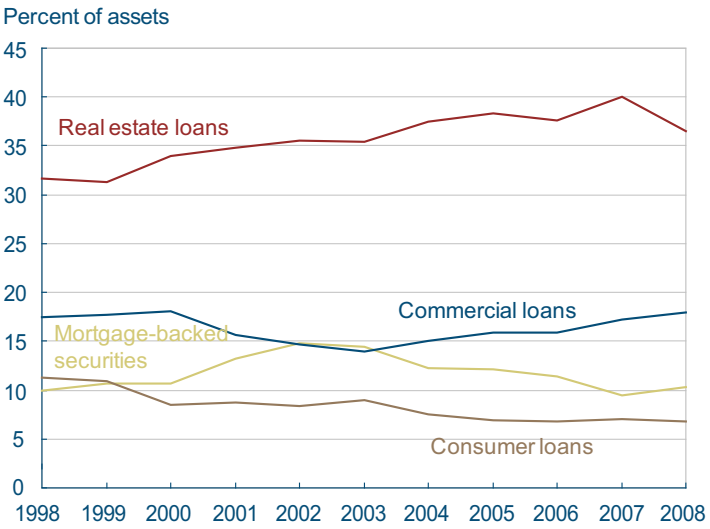
Banks' aggregate return on assets fell below zero during 2008, as the industry continued to grapple with souring loans and a worsening economic climate. In the Fourth District, bank holding companies booked a –0.37 percent return on assets. The net interest margin (NIM)—the spread between the rate at which banks lend and the rate at which they borrow—fell to 2.33 percent from 2.89

Income Stream



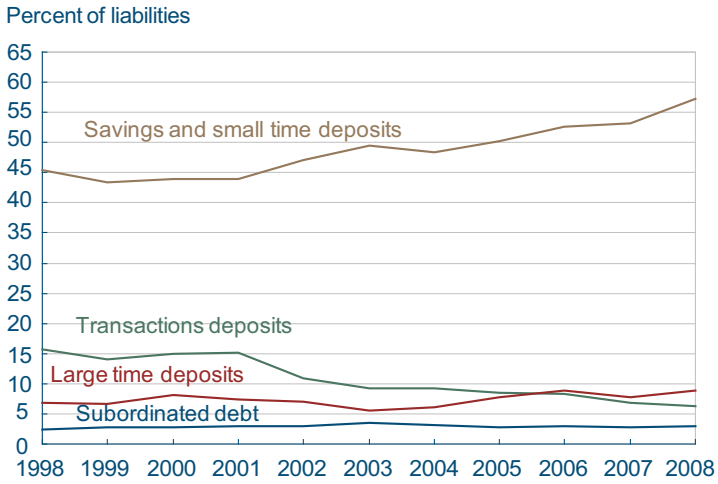
Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Fourth Quarter 2008.

Assets



Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Fourth Quarter 2008.

Liabilities



Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Fourth Quarter 2008.

percent in 2007. Notice that the NIM's decline accelerated during 2007 and into 2008, roughly tracking the fall of short-term interest rates. Since September 2007, the Federal Reserve has lowered the target federal funds rate from 5.25 percent to a range of 0.00 percent –0.25 percent. Although banks benefit from a lower borrowing cost as short-term rates decrease, long-term rates have also stayed relatively low by historical standards, and banks also base many of their loans (especially consumer loans) on the prime rate, which is tied to the fed funds rate.

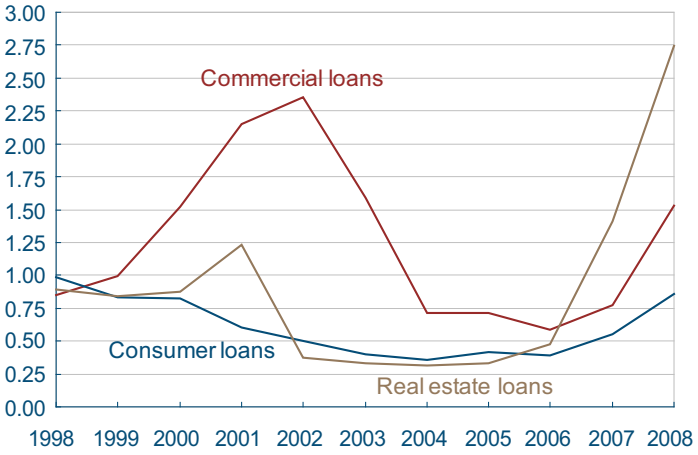
Another indicator used to measure the strength of earnings is the level of income earned but not received. If a loan allows the borrower to pay an amount that does not cover the interest accrued on the loan, the uncollected interest is booked as income even though there is no cash inflow. The assumption is that the unpaid interest will eventually be paid before the loan matures. However, if an economic slowdown forces an unusually large number of borrowers to default on their loans, a bank's capital may be unexpectedly impaired. The levels of Fourth District BHC income earned but not received ticked up modestly from 2005 to 2007 but fell back to 2004 levels (0.46 percent of assets) in 2008.

Real estate continues to be the dominant loan class for Fourth District BHCs, although there was a clear decrease in the portion of assets represented by real estate loans in 2008. Real estate fell to 36.6 percent of assets, from 40.0 percent in 2007. At the same time, commercial loans and mortgage-backed securities saw a slight rise in their representation in loan portfolios. It is not clear whether these increases were the result of concerted portfolio rebalancing at banks; equally likely is the possibility that the rebalancing occurred naturally as the volume of real estate originations (and loan volume generally) slowed during 2008.

Deposits became an increasingly important source of funding for banks in 2008, particularly in the fourth quarter, as individuals shifted assets into savings in a flight-to-quality move, and for liquidity. Savings and small time deposits accounted for 57.3 percent of BHC liabilities, an 8.0 percent increase

Problem Loans

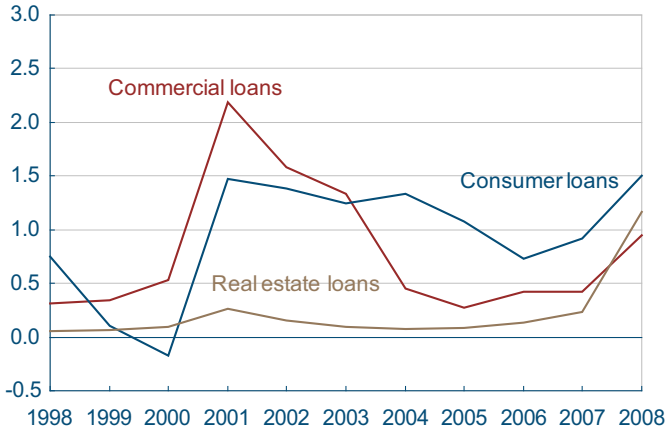
Percent of loans



Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Fourth Quarter 2008.

Net Charge-Offs

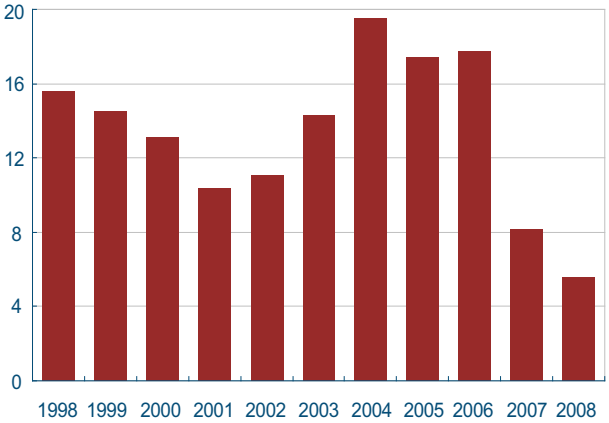
Percent of loans



Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Fourth Quarter 2008.

Coverage Ratio

Dollars



Note: Ratio of capital and loan loss reserves to problem assets.
Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Fourth Quarter 2008.

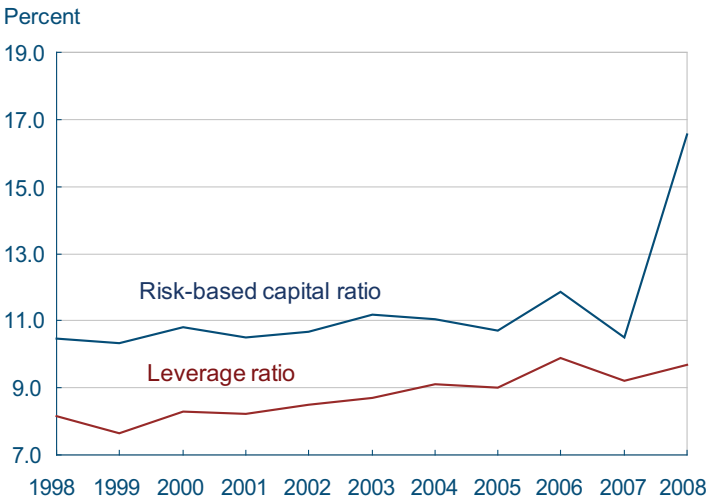
from 2007. Transaction deposits saw a slight decline of 0.67 percent of liabilities, and large time deposits increased to 8.83 percent of liabilities from 7.70 percent in 2007.

Problem loans are loans that are past due for more than 90 days but are still accruing interest payments, as well as loans that are no longer accruing interest. Last year, problem real estate loans hit 2.75 percent of all loansâ€“nearly double the 1.41 rate in 2007. Consumer (credit card, installment) loans and commercial loans also became problematic at a much faster rate in 2008 with the effects of the recession. Approximately 1.53 percent of commercial loans and 0.86 percent of consumer loans were problematic in 2008, up from 0.78 percent and 0.55 percent in 2007, respectively.

BHCs in the Fourth District also charged off more souring loans in 2008 than in previous years. Consumer loan charge-offs, at 1.50 percent, were the highest of the three categories shown. Bad credit card debt, a component of consumer loans, likely accounts for most of this category. Credit card lines were clearly hit by worsening economic conditions, and banks also tend to charge off problematic credit card lines at a faster rate than secured commercial or real estate loans.

Capital is a bank's cushion against unexpected losses. The risk-based capital ratio (a ratio determined by assigning a larger capital charge on riskier assets) for Fourth District BHCs saw a dramatic rise from 10.5 percent of assets in 2007 to 16.5 percent in 2008. During 2008, asset growth slowed, and many banks sought additional capital, including from the government's TARP program. The leverage ratio stayed relatively flat at 9.7 percent (from 9.2 percent in 2007).

Capitalization



Source: Authors' calculation from Federal Financial Institutions Examination Council, Quarterly Banking Reports of Condition and Income, Fourth Quarter 2008.

An alternative measure of balance sheet strength is the coverage ratio. The coverage ratio measures the size of a bank's capital and loan loss reserves relative to its problem assets. This ratio has been falling since 2006, and in 2008, BHCs held about $5.52 of capital and loss reserves per dollar of problem assets. Last year, that number was $8.15.

To read more on the Fourth Quarter 2008 Quarterly Banking Profile: http://www2.fdic.gov/QBP/index.asp

To read more on the flight-to-quality move: http://www.clevelandfed.org/research/trends/2009/0109/01banfin.cfm

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